

Economics Department



LABOUR MARKET REVIEW

Diana Tur
Natalja Viilmann

1/2008

MAIN DEVELOPMENTS IN THE SECOND HALF OF 2007

Compared to the past ten years, 2007 stands out for strong tensions in the labour market where the unemployment rate reached its lowest level, whereas wage growth peaked. The tensions were stronger during the first half-year, but abated slightly in the second half. This Review focuses on labour market developments in the second half of 2007, which witnessed the expected deceleration of the Estonian economic growth. In the last quarter, economic growth slowed so much that first signs of a decrease in labour demand started to appear.

During the first nine months of 2007, the employment rate growth slowed as the pace of economic growth decreased, but the number of employees increased nonetheless (to 662,000 in the third quarter). This erased previous doubts regarding the appearance of potential supply-side constraints. However, no additional labour force was necessary to reach the growth level of 4.5%, where economic growth dropped to in the last quarter of the year, and thus domestic employment growth shrunk close to zero. The decrease in the number of employees in the fourth quarter was not brought about by supply-side but rather demand-side factors. Therefore, no additional tensions appeared on the labour market and the growth of the wage fund continued to decelerate.

In the near future, however, no remarkable growth in labour supply is expected. Rather, the demographic trends and the simplicity of labour migration within the European Union refer to a decrease in domestic labour resources. Additional workforce can be obtained only on account of the economically inactive. The attractiveness of work may be increased by such factors as more flexible working hours, structural (incl. regional) jobs, approximation of available workforce¹ and additional wage growth. The scarcity of available workforce should urge entrepreneurs to focus on increasing productivity and developing more capital-intensive production also in the future.

Although the number of the unemployed decreased by 8,300 in the fourth quarter compared to the previous quarter, unemployment did not increase during that period. The unemployment rate was the lowest in five years, but along with waning labour demand the activity rate of the working age population dropped. It primarily diminished among the most flexible employment groups – people in the age of retirement and the young – which is why median wages drew slightly nearer to average wages (see also Table 1 and Figure 1).

¹ The creation of new jobs in areas where labour resources are available, or recruiting personnel from more distant areas (incl. arranging necessary transportation).

Table 1. Main labour market indicators

	Change y-o-y (%)				Change y-o-y (thousand)									
	2007		2007		2007		2007							
	2005	2006	2007	2007	2005	2006	2007	2007						
Population (as at 1 January)	-0.3	-0.2	-0.2		-3.6	-2.3	-2.3							
Employment status (15 to 74 years old)														
Workforce	0.1	4.1	0.1	0.6	0.1	0.5	27.2	0.6	4.9	0.7	4.3	-7.5		
employed	2.0	6.4	1.4	1.9	1.3	1.9	38.9	9.0	12.3	8.8	12.5	3.1		
manufacturing	-0.9	-2.2	-1.2	6.2	-1.2	-3.7	-6.2	-3.1	-1.6	8.5	-1.6	-5.0	-8.4	
unemployed	-17.9	-22.4	-21.0	-16.9	-18.2	-22.4	-27.2	-11.4	-11.7	-8.5	-7.4	-7.8	-10.5	
less than 6 months	-12.3	-15.6	-14.6	-11.9	-11.8	-26.1	-9.3	-2.6	-2.9	-2.3	-1.9	-2.0	-4.2	-1.3
6 to 11 months	-38.0	-7.0	-47.2	-48.3	-48.5	-44.6	-40.0	-3.5	-0.4	-2.5	-2.8	-3.2	-2.5	-1.2
12 months or more	-16.0	-30.1	-19.0	-12.3	-14.0	-9.8	-36.9	-5.3	-8.4	-3.7	-2.7	-2.7	-1.5	-8.0
24 months or more	-15.3	-37.4	-21.9	-24.8	-25.0	1.3	-30.1	-3.3	-6.8	-2.5	-3.5	-2.9	0.1	-3.7
Inactive	0.1	-6.9	-0.9	-2.0	-1.0	-1.9	1.3	0.3	-26.7	-3.3	-7.5	-3.5	-6.9	4.8
Total	0.1	0.0	-0.3	-0.3	-0.3	-0.3	-0.3	0.8	0.5	-2.7	-2.7	-2.7	-2.7	-2.7
	Level (%)				Change (percentage points)									
Participation rate	62.9	65.5	65.7	65.3	66.3	66.0	65.2	0.0	2.6	0.2	0.6	0.3	0.6	-0.5
Employment rate	57.9	61.6	62.6	61.8	62.9	63.3	62.5	1.1	3.7	1.0	1.3	0.9	1.4	0.5
Unemployment rate	7.9	5.9	4.7	5.3	5.0	4.2	4.1	-1.8	-2.0	-1.2	-1.1	-1.2	-1.2	-1.5
Wages														
	Level (EEK)				Change (%)									
Average gross monthly wages	8,073	9,351	11,260	10,322	11,549	10,899	12,270	10.8	16.2	20.4	20.1	21.2	20.2	20.2
manufacturing	7,526	8,823	10,659	9,784	10,836	10,590	11,424	12.4	17.6	20.8	21.6	22.8	20.0	19.1
Average net monthly wages	6,411	7,524	9,038	8,339	9,269	8,781	9,762	13.0	17.4	20.1	20.0	21.0	20.1	19.1
Minimum wages	2,690	3,000	3,600	3,600	3,600	3,600	3,600	8.5	11.5	20.0	20.0	20.0	20.0	20.0

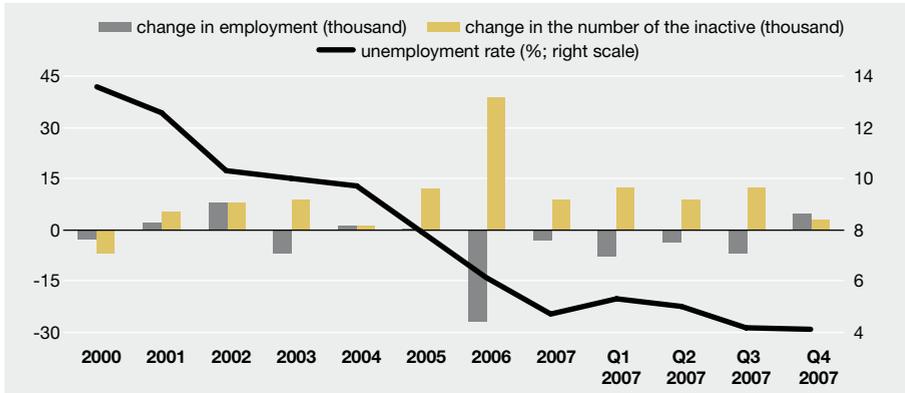


Figure 1. Main labour market indicators

The tensions related to the wage pressures that were considered too strong at the beginning of 2007 started to diminish gradually in the second half of the year. Owing to the great inertness of wage growth, in the near future this indicator is not expected to decelerate to the same extent as nominal economic growth. However, clear signs of a slowdown in private sector wage growth should appear already in the first half of 2008; as for public sector wages, a deceleration may be expected only in 2009.

Since the fourth quarter of 2007, it is possible to talk about relatively rapid adjustment of real wage growth. As inflation picked up considerably in the second half of the year, real wage growth declined from 14.7% in the second quarter to 10.1% in the fourth quarter, i.e. by 4.8 percentage points. In the fourth quarter, the average real growth of net wages was even slightly smaller (9.9%), which means that the effective tax rate² rose slightly in the fourth quarter. According to preliminary estimates, real wage growth decelerated further (to 7–8%) in the first quarter of 2008. Slower real wage growth, in turn, causes a slowdown in private consumption growth. Private consumption is also influenced by the fact that according to the consumer barometer, household confidence regarding their own economic outlook as well as that of the whole country continued to deteriorate at the end of 2007.

In 2007, companies could no longer finance the extremely rapid wage growth through their income, i.e. labour productivity and price growth. Thus, the share of profit in GDP declined relatively fast to levels comparable to 6–7 years ago, although not as extensively in the fourth quarter. Although the share of profit continued to decrease, the growth of unit labour costs showed signs of deceleration in the last quarter. The growth of wage costs, however, was

² The income tax rate remained stable (22%) throughout 2007. However, taking into account the incentives for private persons established in the Income Tax Act (the non-taxable income threshold) one may conclude that the effective tax rate, i.e. the ratio of the tax to the income earned, has risen with the year.

still very rapid at the end of the year. In order to adjust to a slower growth path, the growth rate should diminish considerably.

In the coming years, the labour market and social policies should help maintain a high employment level and creation of new jobs. According to Eesti Pank, it is necessary to make amendments to the Employment Contracts Act, because the current legislation is too rigid in international comparison. The flexibility of the labour market is the key prerequisite for competitiveness, fostering the relocation of labour force from less productive to more competitive companies along with relevant training. Until now, the rapid growth period has disguised the problems in that area, but most probably the bottlenecks will emerge as economic growth slows.

LABOUR SUPPLY AND DEMAND

Labour force participation and economic inactivity

In the second half of 2007, the slowdown of economic growth entailed a decrease in labour force activity. According to the labour force survey, the number of employees aged 15 to 74 was 653,800 in the fourth quarter of 2007 and 28,100 were unemployed. The number of the inactive³, i.e. students, the retired, persons on parental leave or the discouraged, stood at 364,500. In the previous quarters, the number of employees reached 662,000 and that of active workforce totalled 690,000.

In the third quarter, approximately 10,000 of the retired became inactive, but back then it was offset by the economic activity of students that increased with the year. In the fourth quarter, the activity of people in the age of retirement remained at the level of the previous quarter, whereas the number of inactive young students increased (by approximately 9,000 compared to the third quarter). The total number of the inactive grew by 9,000 quarter-on-quarter and by 4,800 year-on-year. Illnesses, injuries and discouragement kept approximately 58,000 people away from the labour market.

The number of the inactive was somewhat boosted also by those inactive because of pregnancy, maternity or parental leave, or attending to children or other family members. Compared to the same quarter in 2006, the number of such people kept growing throughout 2007. The main reasons have been the increasing number of births and the extension of the parental benefit payment period (see Figure 2).

³ A person is inactive when he/she does not work and is not looking for work either.

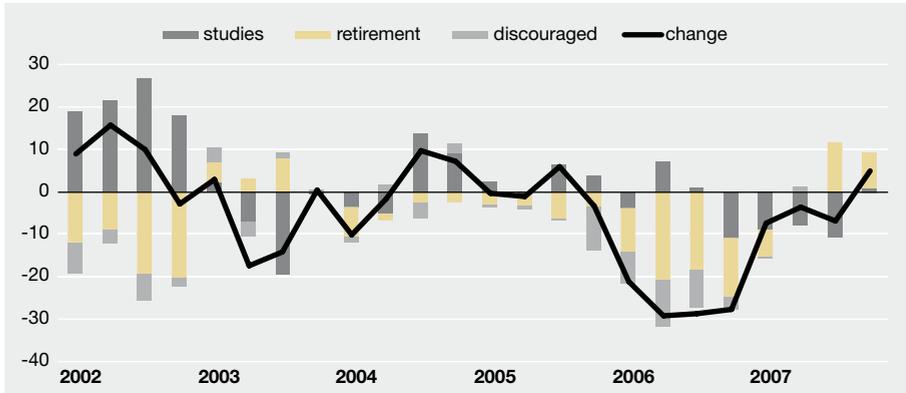


Figure 2. Change in the number of inactive and reasons for inactivity (y-o-y; thousand people)

Along with the growing number of the inactive, the labour participation rate⁴ of the working age population decreased in the fourth quarter of 2007 despite constant growth in the previous quarters. In the fourth quarter, the labour participation rate of people aged 15 to 74 decreased to 65.2% (in the second and third quarters it was about 1 percentage point higher).

The employment rate decreased also nearly as much in the fourth quarter. In the third quarter of 2007, we reached an important milestone: the goal set out in the Lisbon strategy to increase the employment rate of persons aged 15 to 64 to 70% by 2010. In Estonia, this indicator posted 70.2% in the third quarter. In the fourth quarter, however, it dropped slightly below 70% (to 69.3%).

By regions, changes in the number of the inactive remained within the usual volatility range. Only in Harjumaa a slow but steady decrease in inactivity could be discerned in 2007. On the other hand, the number of the inactive climbed in the counties of Lääne-Viru, Ida-Viru and Tartu, where the respective rate has also traditionally been higher than elsewhere in Estonia.

In 2007 as a whole, Estonia's labour force increased owing to the young (aged 15 to 24) and the elderly (50 to 74). The number of the young labour force participants exceeded the previous year's figure by 4,100. Their number increased during the first three quarters but suffered a relatively sudden setback in the fourth quarter. In 2007, labour force included 1,300 more elderly people than a year ago. Their activity also rose remarkably during the first half-year, but in the second half the opposite trends took over. The number of people in the prime working age (aged 25 to 49) decreased by 4,800 during the year. Their labour participation rate dropped from 89.5% in 2006 to 88.5% in 2007 (see Figure 3).

⁴ Labour participation rate equals the weight of the employed and the unemployed in the working age population.

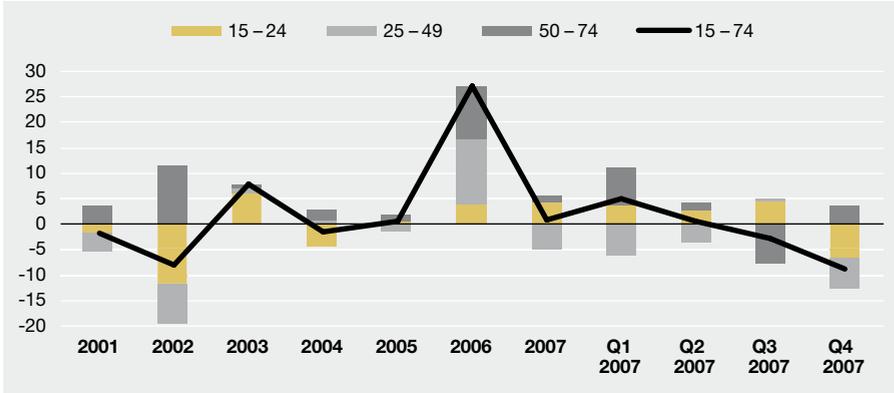


Figure 3. Contribution to employment growth by age groups (thousand people)

Apart from age, people's behaviour on the labour market is also affected by their regional mobility. Although the differences between regions have been shrinking in recent years, the development of the labour market has still been quite uneven across regions. Through times the activity rate has been the highest in Harju County and Tallinn (almost 69–70%). In the past six months, however, activity increased primarily in Central Estonia (see Figure 4).

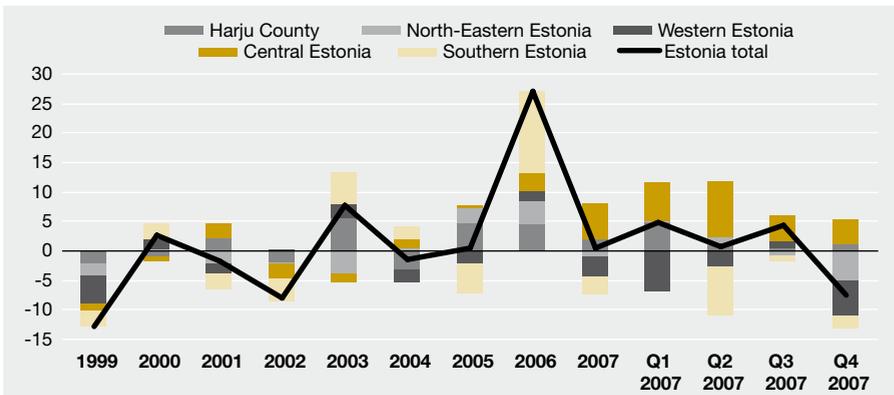


Figure 4. Contribution to employment growth by regions (thousand people)

In addition to labour demand stemming from economic growth, the growth of employment also requires an increase in labour supply. Thus, besides the steadily increasing employment and shrinking unemployment, attention should be paid to decreasing inactivity, primarily with regard to groups for whom the entrance to the labour market is more complicated (e.g. the elderly, the young, workers with low qualifications).

In order to utilise the country's labour resources more effectively and foster the activity of people on the labour market, the variety of benefits and programmes offered via the Labour Market Board has been increased. In earlier years, the main obstacle to employment growth was the lack of vacant positions, whereas recently greater emphasis has been laid on a more vigorous labour supply and alleviation of structural unemployment. Another objective is to diversify forms of working and possibilities of combining work and family life.

The untapped labour resources are mainly among the inactive, but many of them find it difficult to return to the labour market for various reasons. In 2007, the social and market research company Saar Poll conducted a research for the Labour Market Board concerning the economically inactive. It turned out that 13% of the inactive wish to find employment in the near future and 19% are not actively seeking employment but would work if possible. Opportunities to find a job were regarded as poor by 21% and very poor by 10% of the respondents. The main underlying reasons were poor health (45%) and age (16%).

The Ministry of Social Affairs channels all structural aid received from the European Social Fund (ESF) to enhancing professional competitiveness and improving the quality of working life. The maximum aid granted by the ESF to a programme (until the year 2013) is 80% and the maximum amount – 1 billion kroons. With the support of the ESF various national programmes are being implemented, which expand the provision of active labour market measures (e.g. in-service training, retraining and professional traineeship); improve the welfare services that foster obtaining employment and make them more available (e.g. services meant for taking care of children, the elderly and the disabled); enhance the quality of working life (activities aimed at labour legislation and environment), and foster healthy choices and lifestyles.

The first programme financed by the ESF and aimed at increasing qualified labour supply enables, among other things, to provide fast help to persons who have been made redundant and respond to large-scale redundancies. Moreover, career counselling will be provided for a wider target group, including people who are already working or studying but would like to work besides studying. In addition, enterprise support will be continuously granted to the unemployed and the provision of language studies and professional training for non-Estonian unemployed will be fostered.

KEY DEMOGRAPHIC TRENDS

Apart from the economic situation, the number of labour force participants also depends on population changes. The population increases or decreases and this process is subject to births, deaths and the inflow and outflow of labour. During the years after the census of 2000, the Estonian population has decreased every year due to the negative natural increase, although in recent years this process has slightly decelerated. However, the Estonian population count has not taken migration into consideration. Given the relatively active emigration,

it is safe to assume that the actual population is smaller than presented in various statistical data. All the absolute indicators regarding the labour market (incl. the number of the working age population, the employed, the unemployed and the inactive) are probably also smaller. The next census in Estonia will be carried out in 2011.

Based on the existing statistical information, a few characteristics of the Estonian population can be pointed out:

- At the beginning of 2007, the number of people aged 15 to 19, i.e. the young born during 1987–1991 (includes the so-called Singing Revolution generation), was relatively high (102,500). Their economic activity was still relatively low due to studying.
- The next age group, the 20–24-year-olds, was the most numerous (104,800). This is the generation born during 1982–1986, whose labour force participation rate was expectedly higher compared to the younger generation.
- The youngest age group (aged 0 to 4) exceeds the next age group (aged 5 to 9) by 7,600. The disproportional small size (below 70,000) of the three youngest age groups, that is persons aged 0 to 4, 5 to 9 and 10 to 14, stems from the low birth rate of recent years (see Figure 5).

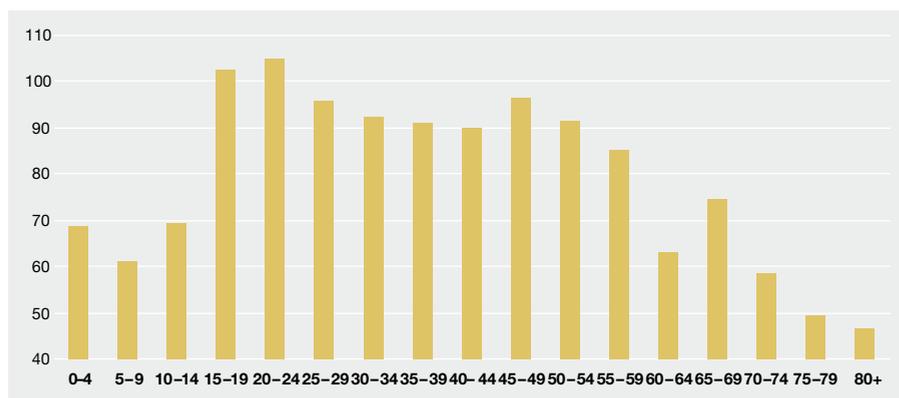


Figure 5. Age structure of the Estonian population as at January 1, 2007 (thousand people)

The **index of demographic pressure on the labour market**, calculated as the ratio of 5 to 14 year-olds and 55 to 64 year-olds, is used to characterise the age structure of the population. This index characterises the proportion of generations entering and leaving the labour market in the near future. In the course of natural developments, the value of the index is above one, which actually describes a certain risk of unemployment for the generation entering the labour market. In Estonia, the value of the index was above one in 2000–2004 but thereafter started to decline rapidly. In 2005, it reached 0.96, which was already then a clear sign of risk and suggested a more acute labour shortage. In 2006–2007, the index

dropped even further (to 0.91 and 0.88, respectively), which means that in the next 5 to 10 years 12% less people will reach working age compared to the number of people leaving that age. Figure 6 shows changes in the share of the young and the elderly. These changes can be explained by a decline in the birth rate in the 1990s and its steady low level.

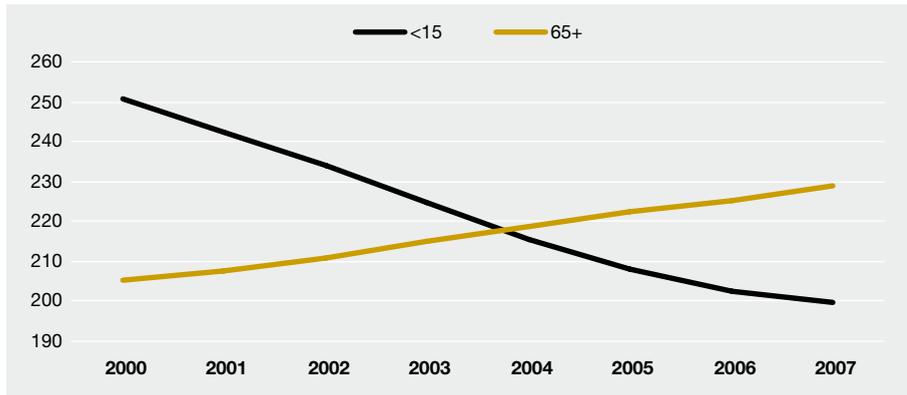


Figure 6. Number of the young and the elderly as at January 1, 2007 (thousand people)

The **dependency ratio** shows the ratio of the total number of dependant generations (i.e. 0 to 14 year-olds and over 65 year-olds) to the number of the working age population (15 to 64 year-olds). The lower the ratio, the smaller is the burden of working people to support the dependants. In Estonia, the children's generation is small and the average life expectancy is relatively low, which is why the dependency ratio is also fairly low. This means that the burden of the working age population is not extensive: there are more than two working age persons per dependant. This indicator has been dropping in recent years (from 49.5% in 2000 to 47.0% in 2007), but a rapid growth in the dependency ratio is to be expected within 5 to 10 years when small cohorts will reach the working age.

All in all, these developments will have important economic consequences. These include changes in the size and composition of labour supply, as the proportion of older workers increases and fewer new workers enter the labour market to replace those leaving it. The same tendencies are characteristic of the entire European Union, including the euro area countries (see background information).

BACKGROUND INFORMATION. SURVEYS REGARDING THE LONG-TERM EFFECTS OF DEMOGRAPHIC PROCESSES⁵

It is difficult to quantify the potential impact of demographic change on labour markets and economic growth. Estimates of such impact are based on a number of assumptions which cannot fully capture the likely correlations between the individual components of economic growth. The European Central Bank has carried out several simulations regarding the impact of alternative labour market developments and the demographic projections on real GDP growth and real GDP-per-capita growth in the euro area. From an accounting perspective, real GDP-per-capita growth can be seen as resulting from increases in labour productivity (defined here as output per employee), labour utilisation (defined here as the ratio of the number of employees to the working age population) and demographic factors, which are captured by the evolution of the various age groups of the population. For instance, under the assumption of unchanged labour utilisation and labour productivity growth in the euro area, demographic trends imply a decline in average real GDP growth from its average 1995–2005 level of 2.1% to around 1% by 2050. Real GDP-per-capita growth will also start to decrease. Implications for public expenditure include increases in public spending on pensions and health care of above 3 percentage points of GDP for most euro area countries.

The qualitative conclusions of the simulations were very similar. Unless structural policy changes, which would increase both labour utilisation and labour productivity, are stepped up significantly, projected demographic developments are likely to imply a significantly lower trend potential output growth (and also a lower trend potential output growth per capita) for the euro area over the medium to long term.

The timely implementation of extensive reforms is needed to prepare for such possible consequences of demographic changes, which would increase the macroeconomic flexibility and dynamism of the euro area. Reduction of public debt would contribute to improving fiscal sustainability and make public finances less vulnerable to the impact of ageing populations. Increasing labour utilisation through policies that support higher labour market participation and employment rates, and increasing labour productivity growth through investment in human capital and the completion of the internal EU market would help to counteract the dampening effects on output growth in the medium run in the euro area. Over a longer time horizon, necessary increases in the statutory retirement age and/or average annual hours of work are also being discussed. The “slow burn” nature of demographic developments suggests that their immediate implications for monetary policy are likely to be moderate.

⁵ This background information is based on the article translated for the Eesti Pank quarterly *The Kroon and Economy* 4/2006-1/2007, “Demographic change in the euro area: projections and consequences” (from the European Central Bank’s Monthly Bulletin).

Various forecast scenarios of the Eurostat also point to a downward trend in the Estonian population. According to the base forecast, for instance, the Estonian population will decrease by approximately 100,000 people by 2018. Nevertheless, considering that as at the beginning of 2008 Eurostat’s base forecast turned out too pessimistic for Estonia (so far, the population has diminished by 12,500, not by 23,000 as the forecast projected), the population decrease may take place twice as slow in the future as well. Actually, the number of young children and people in the age of retirement exceeded the forecast (according to the data of 2007, the figure differed from the forecast by approximately 3,000–4,000), meaning that the number of births and the life expectancy proved to be slightly greater in Estonia. People in the prime working age (aged 25 to 64) deviated from the forecast only by 2,500. Meanwhile, however, Eurostat’s base forecast took into account the negative net migration⁶ of over 2,000 persons from Estonia (the pessimistic forecast even estimated 17,000 persons), which was “overestimated” owing to the lack of actual data (though in reality may turn out to be close to the pessimistic forecast).

The base scenario also expects a rapid outflow of labour force from Estonia in the forthcoming years. This process will start to decelerate in 2013 and as of 2021 net migration will become positive. Usually it is presumed that migration depends on such factors as the difference between the income levels of countries, the likelihood of getting a job, costs related to moving, language and cultural aspects, marital status etc. (see Figure 7).

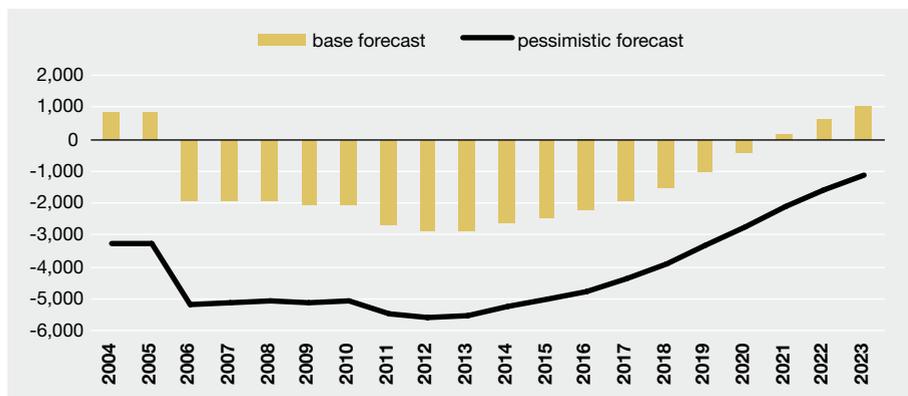


Figure 7. Eurostat’s forecast for net migration in Estonia (people)

Based on an analysis published by the Ministry of Social Affairs, according to various surveys the number of people who have recently considered working abroad compared to the time prior to joining the European Union has dropped by a third. In 2003, 42% of the working age population wished to work abroad, whereas by now their share has decreased to 26%. The

⁶ Net migration equals the difference in the number of immigrants and emigrants.

desire to work abroad has declined the most among people with higher education. According to the Ministry of Social Affairs, the reason for the downward trend is the rapid economic growth and increased labour demand of recent years. Meanwhile, finding a position abroad is considered easier than before. People mainly wish to work in the fields of construction, hotels and restaurants and agriculture. The preferred target countries are Finland and the United Kingdom. The most important reason for working abroad is higher wages. The next reason is to expand one's horizons and gain new experiences, which is considered important by the young in particular.

Employment

Along with slower economic growth, also the growth rate of employees started to decelerate in the second half of 2007. In the first three quarters the growth in the number of employees exceeded the year-ago figures by an average of 1.7%, whereas in the fourth quarter the number of employees was only 0.5% higher than a year ago. Compared to the third quarter, the number of employees dropped by 8,300 to 653,800 and the people who left the labour market became economically inactive. Some former unemployed became inactive as well, and thus the decrease in the number of the unemployed continued in the fourth quarter. If economic slowdown continues, the employment rate will probably diminish even further in the near future.

In 2007 as a whole, the number of employees grew in all age groups. The number of working young people has grown relatively much. The number of employees aged 15 to 24 was by an average of 5,200 bigger than a year ago and their employment rate was about 3 percentage points higher. However, in the fourth quarter, also the employment growth of young employees slowed down and their number even decreased by 3,400 quarter-on-quarter. These young people became inactive again, meaning that employment alongside studies decreased.

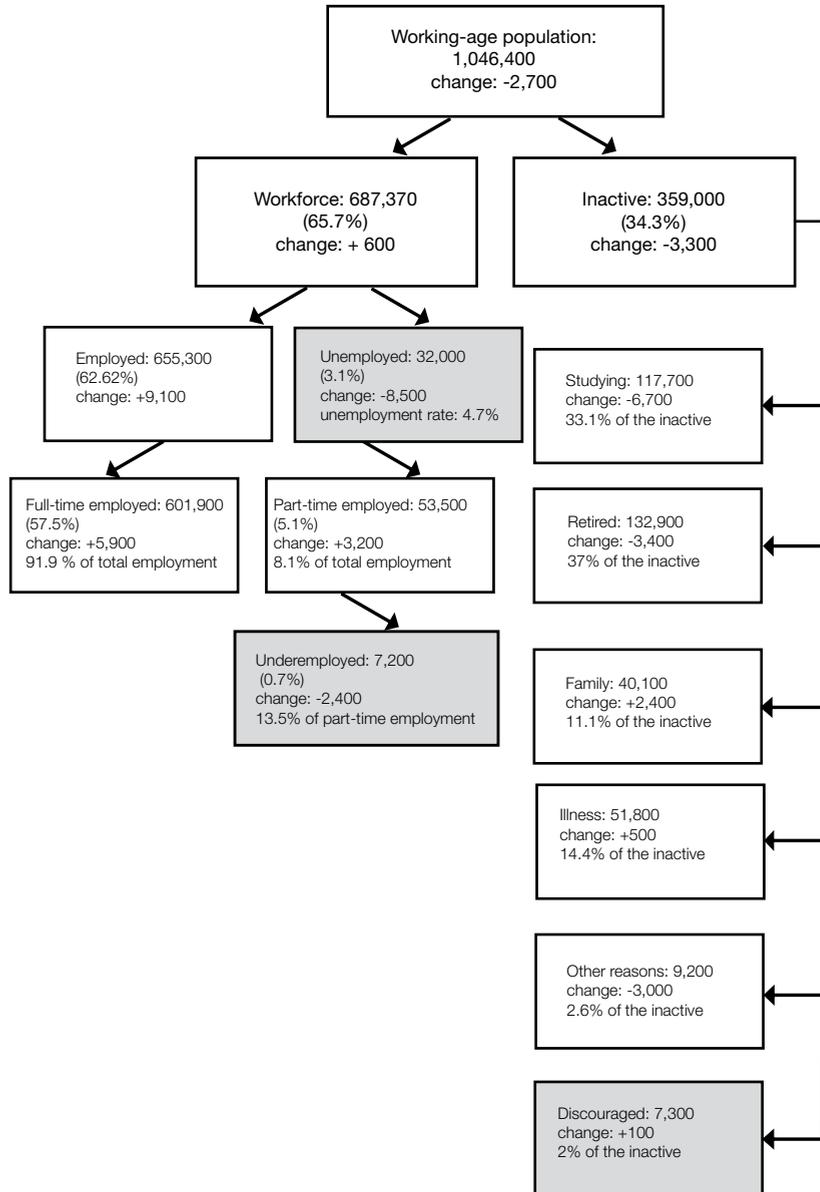


Figure 8. Estonian labour market in 2007 and change compared to 2006 (% of working-age population)

Along with the deceleration of labour demand growth also the structure of employees has changed. The share of part-time workers among those employed in principal jobs has increased. The number of full-time workers dropped in the fourth quarter (by 1,500 year-on-year and by 9,400 quarter-on-quarter), whereas that of part-time workers climbed (by 4,600 and 1,200 respectively). With the year, their share among the employed increased by 0.7% to 8.6% (see Figure 9).

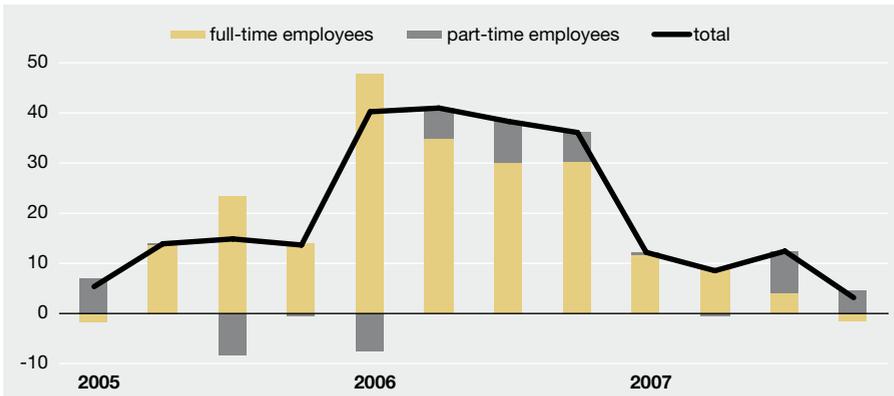


Figure 9. Change in the number of full- and part-time employees (y-o-y; thousand people)

The decline in the number of employees in the fourth quarter, compared to the previous quarter, also meant that the number of salaried workers decreased the most (by 7,300 quarter-on-quarter). The number of the self-employed decreased as well (by 3,500 quarter-on-quarter), but the number of companies with salaried employees increased (by 2,500 quarter-on-quarter) (see Figure 10).

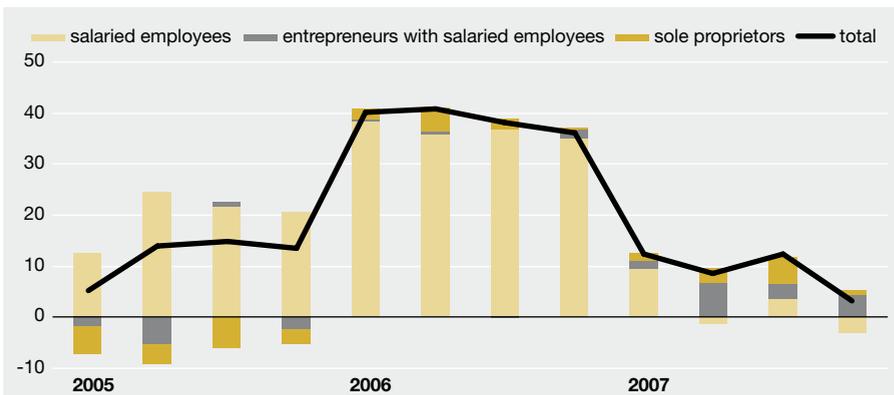


Figure 10. Change in the number of salaried employees and entrepreneurs (y-o-y; thousand people)

As the demand decrease appeared more distinctly only in the fourth quarter, it is difficult to forecast the future long-term tendencies of these changes based on the data of only one quarter. Currently it seems though that the Estonian labour market remains sufficiently flexible. With the arrival of more difficult times, the number of full-time salaried employees has dropped.

As regards fields of activity, the greatest contributor was still the construction sector, but quarter-on-quarter the number of employees in that sector nevertheless fell by 3,500. The number of employees decreased the most in manufacturing and transport: by 8,400 and 8,100 to 6.2% and 13.8%, respectively, year-on-year.

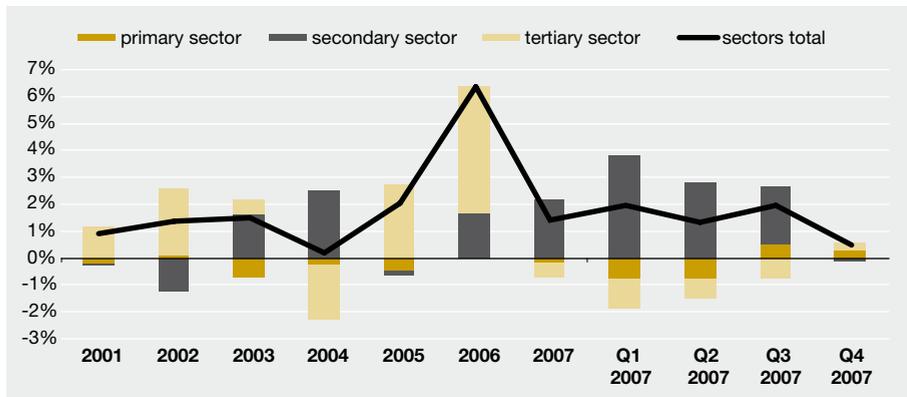


Figure 11. Employment growth and contributions by sectors

The number of employees in manufacturing diminished by 1.2% year-on-year, declining by 1,600 in 2007. In the first quarter the year-on-year employment growth in manufacturing remained clearly positive (6.2%), whereas in the next quarter it became negative and thereafter the situation deteriorated even further, posting -1.6% in the second, -3.8% in the third and -6.2% in the fourth quarter. Although in 2007 the real growth of value added in manufacturing dropped from 11.1% in the first half-year to 5.8% in the second half (and even to 4.9% in the fourth quarter), it was not on account of the deceleration in productivity growth.

In manufacturing the real labour productivity growth⁷ accelerated by 3 percentage points: from 8.4% in the first half-year to 11.4% in the second half (to 11.8% in the fourth quarter). This development might have been influenced by some structural changes. If unemployment decreased the most in those branches of manufacturing that produce lower value added, this would have a positive effect on the average productivity. In conclusion, the acceleration of productivity growth in manufacturing refers to a continuously large growth potential should

⁷ Value added per employee in constant prices.

demand grow. In the second half-year, the nominal labour productivity growth⁸ in manufacturing picked up even further: by almost by 5 percentage points to 21.0%.

By regions, employment growth was positive in 2007 in Western and Northern Estonia. In other regions, the changes were relatively marginal. In North-Eastern Estonia, where the number of employees started to increase along with dynamic economic growth, the situation changed when the economy began to slow. In the fourth quarter, employment growth turned negative again. In Southern Estonia employment declined consistently throughout the year.

By groups of professions, employment growth decreased rather evenly among blue-collar workers⁹ as well as specialists, i.e. white-collar workers¹⁰. The growth of male workers is in line with the rise in the number of construction workers. The decrease of blue-collar workers among female workers might have been caused by some large-scale collective lay-offs (e.g. in the textile company Kreenholm) and weaker demand in the services sector (trade, catering, hotels etc.) in the second half-year.

In 2007, the national structure of employment changed slightly too. In previous years the employment of Estonians grew faster, whereas in 2007 it reached only slightly above zero (1,700, i.e. 0.4%). Meanwhile, the number of non-Estonian workers increased 3.6%, i.e. by 7,400 people. The share of active available workforce among Estonians decreased significantly – the unemployment rate dropped to 3.6% in 2007. Among non-Estonians, the unemployment rate continues to be higher, though in 2007 it decreased from 9.7% to 6.9%. In 2007, the absolute number of the unemployed remained approximately the same in both groups (16,300 Estonians and 15,700 non-Estonians).

In order to estimate the migration within the European Union, we can use the Eurostat's data concerning employment based on the concept of domestic and total employment¹¹. Their difference indicates net migration, i.e. the number of Estonian residents working abroad less the number of residents of other countries working in Estonia (see Table 2).

According to the data of Eurostat, the number of Estonian residents working abroad has been constantly increasing since joining the European Union. Even the inflow of residents of other countries to Estonia has not been able to offset that. Accordingly, domestic employment grew slower than total employment.

⁸ Value added per employee in current prices.

⁹ Blue-collar workers: service and sales staff; skilled workers in agriculture and fishing; skilled workers and craftsmen; operators of equipment and machinery; unskilled workers; military personnel.

¹⁰ White-collar workers: lawmakers, senior officials and executives; specialists and technicians; officials.

¹¹ Total employment includes domestic employment and also Estonian residents working abroad; it does not include non-resident foreigners working in Estonia.

Table 2. National and domestic employment

	National employment	Growth (%)	Domestic employment	Growth (%)	Difference
Q1 2004	592,000	2.2	587,000	2.3	5,000
Q2 2004	597,000	1.1	591,000	0.5	6,000
Q3 2004	600,000	-1.8	595,000	-1.9	5,000
Q4 2004	604,000	-0.4	596,000	-0.9	8,000
Q1 2005	597,000	0.8	590,000	0.5	7,000
Q2 2005	612,000	2.4	607,000	2.7	5,000
Q3 2005	614,000	2.4	609,000	2.3	5,000
Q4 2005	617,000	2.1	611,000	2.5	6,000
Q1 2006	636,000	6.6	627,000	6.2	9,000
Q2 2006	651,000	6.5	641,000	5.6	10,000
Q3 2006	651,000	6.0	640,000	5.1	11,000
Q4 2006	653,000	5.8	640,000	4.7	13,000
Q1 2007	649,000	1.9	632,000	0.8	17,000
Q2 2007	660,000	1.3	645,000	0.6	15,000
Q3 2007	663,000	1.8	648,000	1.2	15,000
Q4 2007	656,000	0.5	641,000	0.2	15,000

Source: Eurostat; authors' calculations

In the first quarter of 2007, the negative balance of net labour migration reached its peak (17,000 people). Thereafter it decreased to 15,000 people and remained at this level also in the third and fourth quarters. In other words, in the second half-year only changes in domestic employment affected the increase/decrease of total employment. The growth rates of these two indicators, however, are still different. For instance, while in the fourth quarter total employment grew 0.5% year-on-year, then domestic employment increased only 0.2%. All other indicators derived from employment figures display differences too. Thus, in the fourth quarter the labour productivity growth rate calculated on the basis of domestic employment was higher than the respective indicator calculated on the basis of total employment: 4.6% vs. 4.3%.

All in all, we may say that the number of employees in the domestic labour market had virtually ceased to increase by the fourth quarter. Meanwhile, migration from Estonia to abroad has also started to decline and the number of those employed abroad has no longer risen. Those who left the labour market rather became inactive instead of going to work abroad. This means that the supply-side constraint that has cropped up as a potential risk in several earlier forecasts of Eesti Pank has not increased.

Vacancies

The Labour Market Board's statistics concerning vacancies are not representative and thus

do not extend to the whole Estonian economy.¹² Nevertheless, the present analysis uses these statistics as one possible indicator of labour demand.

According to the statistics of vacancies, the growth rate of labour demand has shrunk considerably recently. In the last quarter of 2007 as well as the first months of 2008 the number of job announcements even remained smaller than the year-ago figures (see Figure 12).

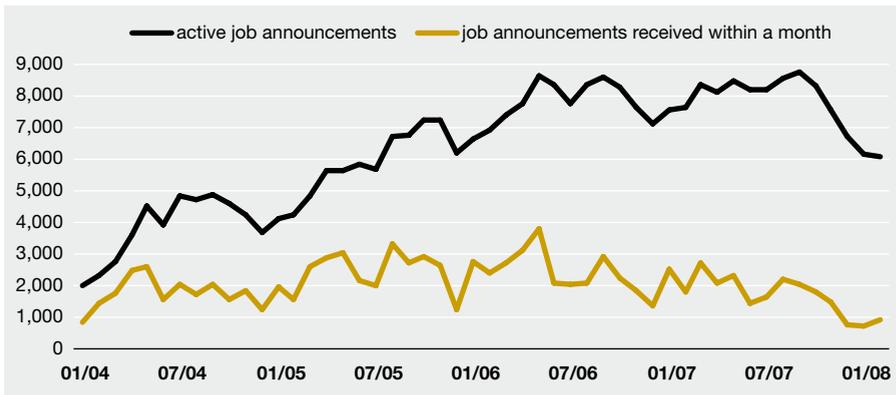


Figure 12. Job announcements submitted to the Labour Market Board

The number of valid job announcements submitted to the Board in the first months of 2008 was nearly 20% smaller and that of new announcements even a half smaller. Considering that supply-side constraints (insufficient qualification of job seekers, outflow of workforce to other countries etc.) have not changed significantly recently, the stabilisation in the number of announcements indicates a decrease in demand-side pressures.

Unemployment

Unemployment diminished throughout 2007 and in the second half of the year this process even picked up pace. During the first two quarters, the number of the unemployed declined an average of 17.6%, i.e. by 7,600 people, year-on-year. In the other half-year, the number of the unemployed declined 24.8%, i.e. by 9,400 people. In the last quarter, the unemployment rate fell to 4.1%. Unemployment was this low 16 years ago (in 1992 before the monetary reform). Last quarter developments, however, differed from those of the previous quarters, because those who left unemployment did not become employed but economically inactive. Thus, this was not about decreasing available labour resources but giving up active job seeking. As discouragement and labour migration have not increased, these people may return to the labour market when labour demand increases.

¹² According to the Statistics Estonia, only 1% of those who found a job during the period under analysis found it through the Labour Market Board.

In 2007, the number of the unemployed continued to decline in terms of both short-term and long-term unemployment. Compared to 2006, the number of long-term unemployed shrank by 3,700, whereas the share of short-term unemployed decreased by 4,800. Although the number of long-term unemployed has fallen remarkably, their share in total unemployment is still high – approximately 50% (see Figure 13).

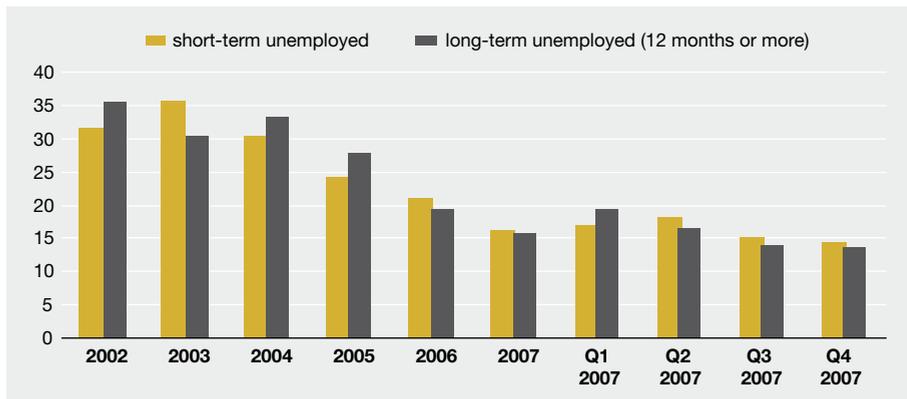


Figure 13. Number of short-term and long-term unemployed (thousand people)

According to Statistics Estonia, in Estonia people with higher education are three times less likely to remain unemployed in the long-term compared to people with primary and basic education. Long-term unemployment is more imminent for the elderly and those who were employed as unskilled workers prior to becoming unemployed. While only every tenth person out of all employees had a basic or lower education, among the unemployed this was the case for every fourth person.

In 2007, unemployment declined in all age groups. The downward trend was especially rapid among the young: compared to 2006 the unemployment rate decreased by 2 percentage points and reached 10%. In 2007, the unemployment rate of people in their prime working age stood at 4.5% and that of the elderly at 3.2%.

The unemployment rate of non-Estonians decreased faster than that of Estonians. The number of the unemployed among Estonians declined by 2,300, whereas among non-Estonians it fell by 6,700.

In the area with the greatest unemployment, North-Eastern Estonia, in 2007 unemployment dropped the most rapidly compared to the year before – by 3.1 percentage points, i.e. by 3,000. Nonetheless, the unemployment rate in this region still remained the highest (9.0% as an average of 2007; 8.3% in the fourth quarter). The unemployment rate fell significantly

also in Southern Estonia, namely by 1.8 percentage points to 4.8%. The lowest unemployment rate was again recorded in Northern Estonia (3.3% as an annual average; 2.6% in the fourth quarter), where it dropped by 0.9 percentage points during the year. All in all, the difference between tax rates across regions has diminished slightly and regional variations have decreased as well.

According to the consumer barometer of the Estonian Institute of Economic Research (EKI), in the final months of 2007 households started to consider the likelihood of becoming unemployed to be greater. At the beginning of 2008, this fear even grew (see Figure 14). The pessimistic estimate remains in line with the changes in the numbers of registered unemployed (Labour Market Board) and receivers of unemployment insurance benefits (Estonian Unemployment Insurance Fund), which exceeded last year's indicators already in September 2007 and were 20% and 30% higher in annual comparison at the beginning of 2008.

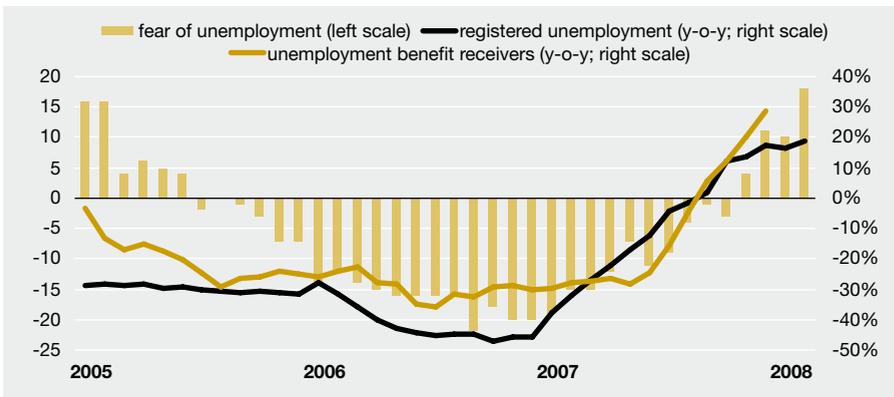


Figure 14. Fear of unemployment and registered unemployment

In recent years, the changes in the number of registered unemployed have generally remained in line with the changes in the total number of the unemployed, although the number of registered unemployed is smaller than the total and thus also more volatile. Meanwhile, the ratio between the number of registered unemployed and the total number of unemployed has changed. In the first half of 2007, approximately 38% of all the unemployed registered themselves as such, whereas in the second half they comprised already over 47% (49.1% in the fourth quarter). If the probability of finding employment is not as high as it was at the peak of demand, people tend to opt for official registration to receive social guarantees, such as health insurance. Nevertheless, in the near future the total number of unemployed is expected to increase.

According to the barometers of EKI, companies' estimates on the number of employees needed in the following three months, compared to the previous year, shrank already in the final months of 2007 (except in construction where the estimates were more modest throughout 2007). Based on this, it may be assumed that in the first half of 2008 employment growth will slow further in the services sector, while in manufacturing and trade it will stabilise or diminish slightly and drop in construction.

LABOUR COSTS AND PRICE PRESSURES

Average wages

Average gross monthly wages continued to increase rapidly in the first half of 2007 due to strong demand. However, in the second half-year the wage growth rate started to stabilise. In 2007, average gross monthly wages grew 20.4%, i.e. over 4 percentage points more than a year ago. In the fourth quarter, the growth rate of average gross monthly wages remained at the level of the previous quarter; year-on-year, it grew 20.2%. In terms of months, the lowest indicator was recorded in December (18.0%).

The average gross wages of part-time and full-time employees in companies, institutions and organisations amounted to 12,270 kroons per month and 72.43 kroons per hour in the fourth quarter. The growth rate of hourly wages did not differ from that of monthly wages, which means that the amounts of bonuses were usual.

Since the fourth quarter of 2007, an adjustment of real wage growth may be perceived. Compared to the robust growth in the first half-year, the growth rate declined by almost 5 percentage points to 10.1%. The main reason for the drop was the sudden acceleration of inflation that reached 9.1% in the fourth quarter.

In the fourth quarter, the nominal and real growth of net wages remained slightly lower compared to gross wages: 19.9% and 9.9%, respectively. This means that the effective tax rate rose slightly in the fourth quarter (see Figure 15). Owing to the rise in the non-taxable income threshold in 2008 from 2,000 to 2,250 kroons, an increase in the growth difference of net and gross wages is to be expected this year. The growth rates of net wages will exceed those of gross wages again by up to 1 percentage point.

Dynamic wage growth has also boosted the growth of relative wages in various fields of activity as well as regions.

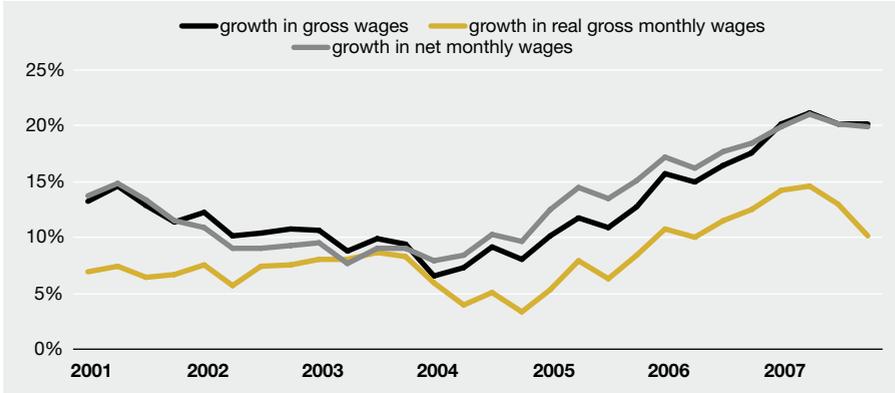


Figure 15. Average wage dynamics

By fields of activity, average wages grew rapidly throughout 2007 in agriculture, mining, construction, financial intermediation and public administration (25–29%). The main reason for rapid growth in the construction sector was the relatively active construction activity in the second half of the year. In the future, however, a deceleration of wage growth may be expected in this sector, primarily due to decreased demand (new orders), as it is difficult to raise construction prices in the environment of increased competition. Thanks to the base effect wage growth rates remain relatively high also in the first quarter of 2008, but will drop then by several percentage points. The total growth of wage costs in construction, however, started to decelerate already in the fourth quarter of 2007, because the number of employees fell compared to the previous quarter. In agriculture, wage growth was boosted by increasing production and higher incomes resulting from price rises. As since 2008 EU structural funds provide considerably more resources, the growth of income in agriculture will probably remain relatively rapid also in the near future. In mining, fourth-quarter wage growth was primarily fostered by the increased production volume in oil shale mining and peat production.

In the second half-year, the growth rate of average gross monthly wages decreased in manufacturing, trade and hotels, which remained in line with the slowdown in value added growth (see Table 3).

By regions, in 2007 average gross monthly wages increased the most in Viljandi and Saare Counties: by 27.3% and 25.8%, year-on-year. According to the Labour Market Board, the wage growth in Saare County was caused by the expansion of existing and formation of new companies as well as the resulting tighter competition and desire to keep current employees. Wage growth has also been stimulated by higher wages in the construction sector, as many working-age men of Saaremaa wish to work in the field of construction in continental

Table 3. Growth in average gross monthly wages by fields of activity (%)

	2004	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007
Average	8.4	10.8	16.5	20.4	20.1	21.2	20.2	20.2
Tradable sector								
Agriculture	13.1	17.2	21.0	26.4	25.1	22.4	28.6	29.6
Forestry	22.9	15.1	8.8	21.1	33.4	27.2	15.2	8.5
Fishery	-1.4	3.3	55.3	16.8	-3.1	-1.4	27.6	44.0
Mining and quarrying	6.6	0.5	15.3	27.8	19.8	38.8	23.8	28.6
Manufacturing	8.4	12.4	17.5	20.9	21.6	22.8	20.0	19.1
Non-tradable sector								
Electricity, gas and water supply	6.0	13.6	7.8	20.6	18.0	22.3	19.3	22.8
Construction	11.7	14.6	19.1	28.4	24.2	32.1	28.5	28.7
Wholesale and retail trade	2.6	7.1	21.6	19.4	22.4	20.5	17.8	17.0
Hotels and restaurants	8.5	22.1	12.7	18.0	20.7	17.3	17.9	16.3
Transport, storage and communications	9.3	10.7	13.7	24.0	28.7	21.1	21.6	24.6
Financial intermedia-tion	3.0	9.8	2.4	26.3	29.1	27.5	22.1	26.4
Real estate, renting and business activities	15.4	6.1	16.1	7.2	5.4	5.9	7.2	10.3
Public administration and defence	8.2	9.6	13.7	24.8	23.7	25.6	24.7	25.1
Education	10.3	11.4	10.3	18.2	16.9	17.5	18.0	20.3
Health care and social welfare	13.9	21.0	14.3	22.0	15.3	26.6	25.0	21.1
Other	14.3	12.2	12.3	22.1	23.3	21.6	22.9	20.7

Estonia as well as abroad. The slowest wage growth was registered in Hiiumaa (15.2%) and Harjumaa (18.8%). Average wages are still the highest in Tallinn and Harjumaa, reaching almost 14,000 kroons in the fourth quarter of 2007. However, as wage growth was relatively slower in Harjumaa, the large differences between the wages in Harjumaa and other regions decreased even further.

Regarding the owner of the place of employment, the situation of economic sectors has changed compared to 2006. In 2006, wages grew more robustly in the private sector, whereas in 2007 wage growth was more rapid in the public sector (22.9%). The growth of average gross monthly wages was the slowest in foreign-owned companies (17.0%); as regards companies belonging to Estonian private persons that indicator was 4.6 percentage points higher. Private sector wages responded more strongly to the slower demand growth in the middle of the year (see Figure 16).

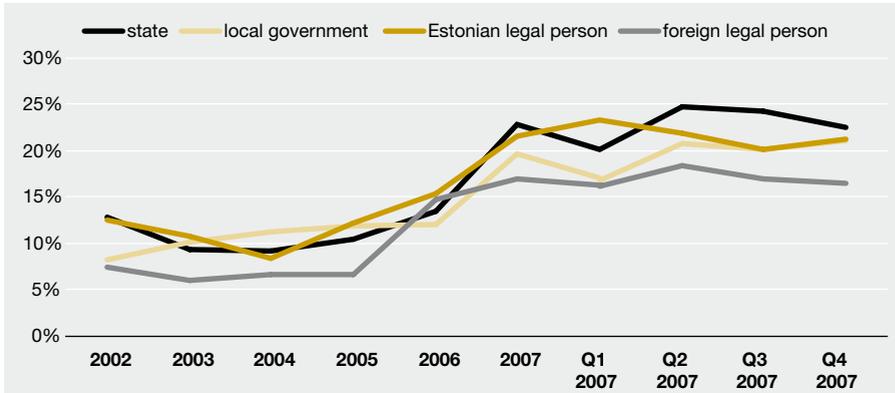


Figure 16. Average wage growth by the owner of the place of employment

The wage growth of the public sector generally responds faster to changes in the economic environment. In the medium term, however, wage growth pressures are not expected to strengthen. Thus, in 2008 when nominal economic growth slows, public sector wage growth is likely to remain rapid and exceed that of the private sector. The slowdown of public sector wage growth, however, should be a goal for the 2009 budget.

Although the growth rate of average wages remained relatively brisk also in the last quarter of the year, the total growth of wage costs decelerated by 2.5 percentage points quarter-on-quarter. This was caused by a decrease in the number of wage earners as well as the increasing share of part-time employees.

According to various estimates, future outlooks appear to be more modest. Surveys of the Estonian Institute of Economic Research reflect the pessimism of manufacturing and construction companies regarding the opportunities of increasing prices and recruiting new personnel. In the construction sector, a fall in prices and number of employees is expected; in manufacturing, the number of employees will probably remain stable and price growth will decelerate. In trade, the number of employees will probably rise but much slower than a year ago; the price rise will be fast rather than slow. As regards the services sector, the growth of both prices and employment will continue but the growth rate will presumably decrease. All this also narrows down wage growth opportunities, all the more so because the problem of unemployment is not so pronounced anymore.

In conclusion, the labour market responded to the deceleration of economic growth mainly via changes in employment and average wages still rose quite steadily. The growth of wage costs remained far above nominal economic growth. In the fourth quarter, however, it dropped more than nominal GDP growth, which slightly decreased the differences in growth rates.

Unit labour costs

As wage increase exceeded economic growth, also the cost of human capital rose relatively faster. The labour market has become increasingly open and offers workers more choices, including opportunities to work abroad. Keeping up with the wage competition became an increasingly important source of wage pressures for entrepreneurs, also because the competitors are not only foreign employers but also domestic employers from various other fields of activity. Although the construction boom has subsided, the wage levels achieved at its peak (in construction as well as other related areas) will be indirectly affecting the wage levels also in other fields of activity. People's reservation wage¹³ has climbed and accepting a less paid position may be psychologically difficult.

Based on the short-term statistics that characterise the economic situation of companies, reflecting the operation of non-financial companies in current prices¹⁴, it may be concluded that wage fund growth exceeded value added growth by more than 6 percentage points in 2007 (27.1% vs. 20.9%). This means that corporate profit growth was weaker, though still positive, decelerating from 35.3% to 12.8%.

Year-on-year, profits decreased in transport and production of furniture. The growth decelerated the most in areas related to real estate and trade (by 28–29 percentage points to 9.5%). Profit growth was smaller than that of wage costs also in the production of timber, chemical products and construction materials as well as in construction and hotels. In 2007, the total profit of manufacturing companies nevertheless grew faster than labour costs, mainly owing to the increased production volumes of food, paper and metal products and communication devices. However, this changed in the last quarter when profit growth halted. Compared to the same quarter last year, it decreased in timber and furniture industry, production of communication devices as well as in trade, transport and real estate. According to business statistics, the growth of value added was negative in transport and timber manufacturing in the fourth quarter.

The GDP statistics calculated on the basis of a more complex methodology reflects similar estimates regarding the situation of wage growth and productivity. In the previous five years (2002–2006) the proportion of labour costs and profit in GDP remained stable and almost equal, whereas in 2007 the share of labour costs increased rapidly and mainly on account of profits (see Figure 17).

¹³ The lowest wage rate at which a worker would be willing to accept a job.

¹⁴ Does not include data on budgetary agencies and organisations, non-profit organisations, foundations, self-employed persons or financial intermediaries. Based on the number of employees, every company with at least 20 employees is monitored, except in manufacturing where companies with at least 50 employees are monitored. As for small companies, a random selection is made.

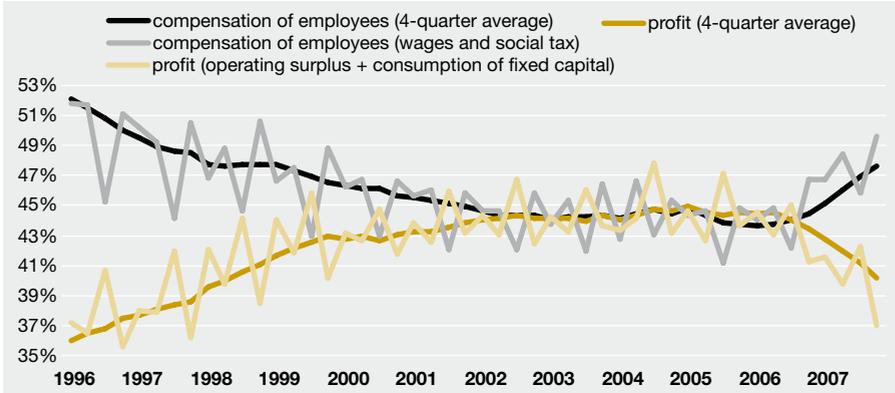


Figure 17. Share of labour cost and profit in GDP

The last time Estonia witnessed such proportions of labour costs and profits as in 2007 was 8–9 years ago. Compared to other countries, labour costs have been relatively low in Estonia (44% in 2006; 47% in 2007, i.e. similar to the euro area indicator) (see Figure 18). However, in international comparison of wage and profit distribution it cannot be claimed that the small share of wages is a significant factor determining competitiveness. Generally, labour costs are higher in more advanced countries where the percentage of services in the economy is higher. In countries with capital-intensive industries prevailing, the share of wage costs is smaller.

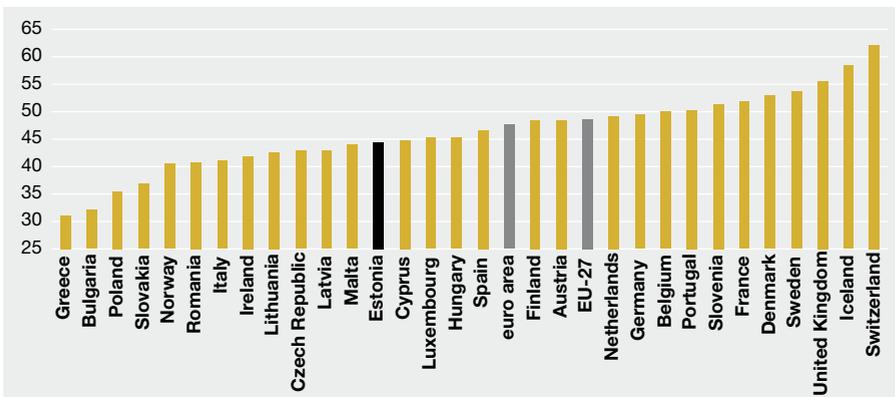


Figure 18. Share of labour costs in GDP in 2006 (%)

Based on GDP statistics it is also possible to calculate the real and nominal unit labour costs in the total economy as well as across economic sectors.

The *real unit labour cost* indicator compares the amount of expenditure per employee (mostly wages and taxes on labour) and labour productivity (per employee) at current prices. Practically, the share of the value added spent on wages is calculated. Following the definition, the growth rate of unit labour costs is positive when labour costs per salaried employee grow faster than labour productivity in nominal terms. When real unit labour costs increase, it normally indicates a decrease in the employer's profit share in the value added (GDP).

Nominal unit labour costs compare labour costs per employee with real productivity, not with productivity calculated at current prices. The aim is to analyse inflationary pressures arising from wage growth, as enterprises have to increase prices of their products in order to retain profitability when wage growth exceeds productivity.

In 2007, the growth of real unit labour costs picked up to 8.3% from 1.6% in 2006, which was related to a higher increase in wage costs compared to economic growth (see Figure 19). Such a great difference is not sustainable in the long term. However, during the year this tendency changed slightly: in the first half-year the growth of unit labour costs accelerated from 7.8% in the first quarter to 9.5% in the second quarter and continued speeding up also in the third quarter (to 10.1%), whereas in the fourth quarter the pace slowed down to 7.3%. This may still be considered a strong growth, but the reversal of the trend implies a possible deceleration also in the future. In 2007, the growth of nominal unit labour costs accelerated to 18.8%. Generally, this also entails strong inflationary pressures. The growth of nominal unit labour costs was especially strong compared to that of real unit labour costs, meaning that during this period the growth of GDP deflator reached its peak in recent years. The growth of nominal unit labour costs also decelerated slightly in the last quarter. Compared to earlier periods, the growth rates of both real and nominal unit labour costs were exceptionally high in 2007.

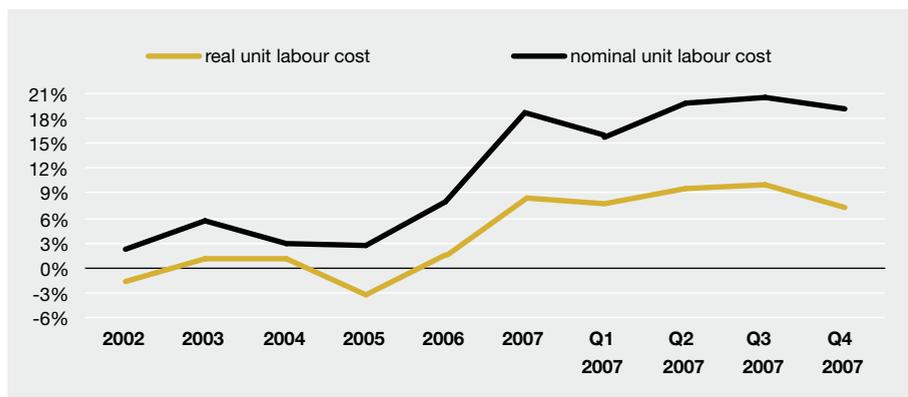


Figure 19. Unit labour cost growth

By economic sectors¹⁵, in 2007 real unit labour costs grew faster than average in hotels and restaurants as well as transport and communication, but also in agriculture and construction. Domestic market oriented sectors, which had been enjoying strong wage growth stemming from the dynamic economic expansion, started to limit their profit growth potential as economic growth slowed. If these sectors respond to the changed economic situation adequately in the near future, both wage increase and real unit labour cost growth should start to decelerate in these fields in less than a year from now.

In manufacturing, real unit labour costs have been growing quite modestly in recent years, and the growth of wage costs has reacted rapidly to the changing growth rates of value added (see Figure 20).



Figure 20. Unit labour cost growth in manufacturing

Compared to 2006, in 2007 the growth of real unit labour costs in manufacturing accelerated by 1.2 percentage points. Considering that maintaining the competitiveness of manufacturing companies is especially important for the economy since a large part of its production is exported, the appreciation of real unit labour costs in manufacturing is not desirable in the long term.

In the first half of 2007, real unit labour costs increased relatively moderately in manufacturing (by 3.5%). In the third quarter, growth was somewhat stronger, as value added growth started to slow, whereas the increase in wage costs remained stable. The changes in the fourth quarter were all the more positive because in the conditions of slower value added growth also wage growth was curbed relatively more and the growth rate of real unit labour costs was the lowest of the year (3.2%).

¹⁵ Only data concerning total employment are applicable in this case.

INSTITUTIONAL DEVELOPMENTS OF THE LABOUR MARKET

Minimum wage in Estonia

On November 21, 2007, the Board of the Confederation of Estonian Trade Unions (EAKL) and the Estonian Employers' Confederation (ETKL) concluded an agreement, according to which the national minimum rate of monthly wages was increased to 4,350 kroons (3,600 kroons in 2007) and the minimum hourly wage rate to 27 kroons (21.50 in 2007). Compared to 2007, minimum wages increased 20.8% and hourly wages 25.6%. According to different estimates, the number of minimum wage earners in Estonia varies from 15,000 to 17,000.

Compared to the OECD Member States and other Central and Eastern European countries, Estonia's minimum wages have remained at low levels for a relatively long time. In recent years, however, they have risen faster than average wages. At the beginning of 2008, minimum wages comprised 35.4% of average wages in Estonia. According to prior agreements, minimum wages should reach 41% of average gross monthly wages in the next few years. If the agreed increase of minimum wages is implemented, the ratio of minimum to median wages in Estonia will be exceeding the EU average.

Changes in the Income Tax Act

Pursuant to the Income Tax Amendment Act, the income tax rate was reduced to 21% on January 1, 2008 (22% in 2007). The income tax rate on fringe benefits, dividends and other payments was changed as well: to 21% as of 2008 (22% in 2007).

Pursuant to the Income Tax Amendment Act passed in summer 2007, the income tax rate will be lowered every year until 2011 by 1% per annum. In 2008, the income tax rate is 21%; in 2009 it will be 20%; 19% in 2010 and 18% as of 2011.

Lowering the income tax rate curbs the rise of the individual effective income tax rate (in 2008 by approximately 0.6–0.8 percentage points), which in the conditions of strong gross wage growth would otherwise increase by a similar amount in a year (e.g. from 19.2% in the first quarter to 19.9% in the fourth quarter of 2007).

In 2008, also the monthly rate of the non-taxable income threshold of natural persons was increased to 2,250 kroons (2,000 kroons in 2007). Thus, the annual rate is now 27,000 kroons (24,000 kroons in 2007). Pursuant to the Income Tax Act, the non-taxable income threshold will rise until 2010 by 3,000 kroons per year. In 2008, the non-taxable income threshold is 27,000 kroons; in 2009 it will be 30,000 kroons and in 2010 as much as 33,000 kroons¹⁶.

¹⁶ Section 23 of the Income Tax Act.

The increase in the non-taxable income threshold of natural persons will lower the effective tax rate even further (by an additional 0.5 percentage points in 2008), causing a stronger growth of net wages compared to gross wage growth. In 2008, the growth rate difference will be an estimated 1 percentage point.

Starting from the 2008 income tax return, a person raising children, usually a parent, is entitled to additional non-taxable income per every up to 17 year-old child. If the child has earned income too, the non-taxable income will be applied to the child's income and the parent is entitled to additional non-taxable income less the child's income. Only one parent is entitled to the incentive. If parents fail to reach an agreement in this matter, the incentive will be paid to the parent who receives child allowance as laid down in Section 5 of the State Family Benefits Act¹⁷.

Changes in the Social Tax Act

Since January 1, 2008, the monthly rate that serves as the basis for the minimum social tax liability rose from 2,000 to 2,700 kroons, i.e. by 35%. In 2009, the monthly rate for the minimum social tax liability will reach the level of the previous year's minimum monthly wages, meaning that in 2009 it will climb to 4,350 kroons (by 61.1%).

According to the Ministry of Financial Affairs, raising the minimum social tax liability will increase the collection of social taxes by 0.8–1.0 percentage points in 2008.

Changes in the Holidays Act

On January 1, 2008, the parental benefit payment period was extended to 575 days or until the child reaches 18 months of age. Paternal leave was extended by 10 working days, for which the father will receive holiday pay based on his average wages (in 2007 fathers were entitled to 14 days of paternal leave and the pay amounted to 66 kroons per calendar day).

At their request, the mother or father is granted an additional child care leave of 3 to 6 working days for every working year (3 to 6 calendar days in 2007).

Changes in Aliens Act

On March 12, 2008, the Riigikogu approved the amendments to the Aliens Act, which considerably simplify the bureaucracy related to foreign workforce and double the immigration limit. Pursuant to the amendments, the time limits of proceedings will be shortened and the red tape upon the registration of foreigners for short-term employment and upon applying for

¹⁷ Section 231 of the Income Tax Act.

residence permits for long-term employment will be reduced. The principle is that importing foreign work force is justified in case of qualified labour, for which a wage criterion will be established.

The immigration limit was increased from 0.05% to 0.1% of the permanent Estonian residents, meaning that in a year about 1,350 people may move to Estonia for employment purposes. The currently valid quota allows the immigration of 677 well qualified workers on the condition that the required workforce cannot be found from Estonia or any other EU country. The citizens of Japan and the US as well as persons with Estonian nationality who have a residence permit on other grounds are allowed to work in Estonia outside the immigration limit.

Already in the near future the country will be considerably more tolerant towards temporary employment in Estonia; that is, employment up to six months. For instance, for an equipment installer or skilled worker to be able to work in Estonia temporarily, no approval from the government or the interior minister will be required.

In order to avoid the inflow of cheap workforce to Estonia, the employer has to pay all temporary employees considerably above-average wages. Wages must not be lower than average wages multiplied by the coefficient of 1.24; that is 15,215 kroons. That criterion (average wages multiplied by 1.24) does not apply to the following positions: creative workers; teachers or lecturers; persons conducting scientific research, having the appropriate professional training or experience; sportsmen, coaches, referees or sports officials; trainees sent by a foreign educational institution or student organisation; and the service personnel of a diplomatic representation of a foreign state.

With the old procedures, it took 6-7 months to import employees; if the law is passed this period may shorten to 2-3 months. Partially, this will be achieved by simplifying the proceedings, but partially also because the time limit for publicly seeking suitable employees from the European Union is reduced from two months to three weeks.

The changes were fully supported also by the Estonian Employers' Confederation. Based on a survey conducted by the Estonian Employers' Confederation, in 2007 at least 22 Estonian companies wished to hire a total of 1,500 workers from abroad.

Draft act to amend the Employment Contracts Act

The government's action programme for 2007–2011 has established updating and increasing the flexibility of the labour market as a crucial goal. The legal basis for the implementation of active labour policy is more or less in place, but the outdated labour legislation needs to be modernised. The current Employment Contracts Act of the Republic of Estonia dates from

1992 and needs extensive amendments, because it fails to meet the requirements of the modern labour market.

On January 10, 2008, the Ministry of Social Affairs presented a draft of the Employment Contracts Act, which instigated lively discussions. With the elaboration of the Employment Contracts Act, the necessity of improving the flexibility of the Estonian labour market has been brought up again.

The draft Employment Contracts Act regulates the relations between employers and employees, including the conclusion, amendment and termination of employment contracts, the rights and obligations of the parties, work and rest periods and vacations. The underlying principle is to guarantee safe flexibility for employees as well as employers. In order to achieve safe flexibility three goals have been established: to introduce new flexible forms of working, increase the security of employees and protect their income. These goals are backed by changes related to the social securities system, supporting training opportunities and lifelong learning and the expansion of the counselling system offered by the Labour Market Board based on individual needs. The Employment Contracts Act, Working and Rest Time Act, Holidays Act, Wages Act and the Employees Disciplinary Punishments Act will be integrated into one act.

The representatives of employees resisted most strongly to the clauses that provided for the decrease in redundancy payments and the shortening of the term for notices of redundancy. The redundancy payment would be reduced to one average monthly wage regardless of the length of employment. The term for notice of redundancy has been adjusted to the minimum level of the revised and amended European Social Charter (from 10 to 40 working days). On March 6-7, 2008, a meeting took place among social partners in order to discuss the proposals concerning the draft Employment Contracts Act. The participants included representatives of the Confederation of Estonian Trade Unions, the Estonian Employees' Unions Confederation (TALO), the Estonian Employers' Confederation and the Estonian Chamber of Commerce and Industry. On March 24, all the parties assembled again but still did not reach a consensus.

The adoption of the draft Employment Contracts Act may improve the mobility of employees and working places, diminish the burden of entrepreneurs in guaranteeing social protection for workers and enlarge the opportunities to introduce more flexible working forms. The draft's impact on the protection of incomes remains rather vague at this time point: increasing the unemployment security benefit by 10 percentage points does not compensate for shortening the term for notice of redundancy and reducing redundancy payments (especially as it only concerns some employees who pay insurance premiums), but the decreased obligations and greater mobility of entrepreneurs as well as active labour market policy measures might provide higher incomes in the long term.

SUMMARY

- Compared to the past ten years, 2007 will stand out for strong tensions on the labour market where the unemployment rate reached its lowest level, whereas wage growth peaked. The tensions were stronger in the first half-year, but abated slightly in the second half. In the last quarter, economic growth decelerated so much that first signs of a decrease in labour demand started to appear – the number of employees dropped and wage fund growth slowed.
- The labour demand oriented at the domestic market is declining due to demographic processes as well as better working opportunities outside Estonia. Additional workforce can be obtained mainly on account of the economically inactive; entrepreneurs should also keep their focus on enhancing productivity.
- The Estonian labour market is again testing its flexibility. It responded to the decreasing demand relatively rapidly through employment: when labour demand subsided, the activity of the working age population declined mainly among people in the age of retirement and the young; the number of wage earners and full-time employees dropped. Average gross wage growth remained brisk, whereas wage fund growth slowed. The growth of wage costs was still considerably stronger than economic growth.
- Developments in manufacturing, which is a tradable sector, have so far remained more in line with productivity growth: when demand growth slowed, the number of jobs fell and productivity growth picked up.
- The growth of unit labour costs, which was one of the causes for stronger inflationary pressures in 2007, also started to decelerate in the fourth quarter. The growth of wage costs still remained too rapid and caused a further decline in profitability, although the decline was slower than earlier. As economic developments are cyclical, the forthcoming periods should display more distinct signs of improvement.

Table 4. Estonian labour market

		2004	2005	2006	2007
Population (as at January 1)	thousand	1,351.1	1,347.0	1,344.7	1,342.4
Employment status (15 to 74 year-olds)		2004	2005	2006	2007
Workforce	thousand	659.1	659.6	686.8	687.4
employed	thousand	595.5	607.4	646.3	655.3
unemployed	thousand	63.6	52.2	40.5	32.0
Inactive	thousand	388.7	389.0	362.3	359.0
Total	thousand	1,047.8	1,048.6	1,049.1	1,046.4
Labour participation rate	%	62.9	62.9	65.5	65.7
Employment rate	%	56.8	57.9	61.6	62.6
Unemployment rate	%	9.7	7.9	5.9	4.7

Employment by fields of activity		2004	2005	2006	2007
Agriculture, forestry and fishery	thousand	35.0	32.2	31.1	30.9
Mining and quarrying	thousand	8.0	5.9	5.2	5.5
Manufacturing	thousand	140.9	139.5	136.4	134.8
Electricity, gas and water supply	thousand	12.0	12.5	12.4	9.5
Construction	thousand	46.8	48.7	62.8	80.9
Wholesale and retail trade	thousand	80.0	80.6	88.7	88.1
Hotels and restaurants	thousand	16.2	22.1	22.3	22.8
Transport, storage and communications	thousand	51.5	54.6	61.5	58.4
Financial intermediation	thousand	7.9	6.9	7.3	9.4
Real estate, renting and business activities	thousand	39.4	46.4	48.1	49.5
Public administration and defence	thousand	36.9	37.2	39.0	39.2
Education	thousand	54.5	54.9	58.5	54.5
Health care	thousand	37.5	35.0	37.5	36.4
Other	thousand	28.8	31.1	34.3	35.6
Unemployed by duration of unemployment		2004	2005	2006	2007
Less than 6 months	thousand	21.2	18.6	15.7	13.4
6 to 11 months	thousand	9.2	5.7	5.3	2.8
12 months or more	thousand	33.2	27.9	19.5	15.8
24 months or more	thousand	21.5	18.2	11.4	8.9
Inactive by reason of inactivity		2004	2005	2006	2007
Studies	thousand	123.1	126.1	124.4	117.7
Illness or disability	thousand	43.3	47.0	51.3	51.8
Pregnancy, maternity or parental leave	thousand	27.2	27.1	23.8	26.5
Need to take care of children or other family members	thousand	13.7	14.0	13.9	13.6
Retirement age	thousand	149.4	145.4	129.5	132.9
Discouraged people (lost hope to find work)	thousand	17.7	14.7	7.2	7.3
Other	thousand	14.4	14.6	12.2	9.2
Workforce by level of education		2004	2005	2006	2007
First level and less	thousand	73.2	65.1	75.3	72.5
Second level	thousand	375.6	367.4	376.4	383.4
Third level	thousand	210.3	227.0	235.0	231.5
vocational secondary education	thousand	70.0	67.6	70.5	70.3
higher education	thousand	140.4	159.5	164.6	161.2